provided in the regulations under section 338 or by the Commissioner, new target is treated as a continuation of old target for purposes other than subtitle A. For example—

(i) New target is liable for old target's federal income tax liabilities, including tax liabilities resulting from the deemed asset sale and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see § 1.1502–6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number.

[T.D. 8515, 59 FR 2966, Jan. 20, 1994, as amended by T.D. 8626, 60 FR 54944, Oct. 27, 1995; T.D. 8760, 63 FR 4178, Jan. 28, 1998]

§ 1.338–3 Deemed sale and aggregate deemed sale price.

(a) *Scope.* This section provides guidance regarding the recognition of gain or loss on the deemed sale of target affiliate stock. This section also provides guidance regarding the determination of the price (the aggregate deemed sale price) at which old target is treated as selling its assets in the section 338(a)(1) deemed sale for purposes of determining the gain or loss recognized by target in the deemed sale. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation of section 338.

(b) *Definitions.* For purposes of the regulations under section 338:

(1) *ADSP.* The *ADSP* is the aggregate deemed sale price, i.e., the price at which target is deemed to have sold all of its assets in the deemed sale under section 338(a)(1). See paragraph (d) of this section for the determination of the ADSP.

(2) *Allocable ADSP amount.* The *allocable ADSP amount* is the portion of the ADSP that is allocable to a particular target asset. Deemed sale gain on a target asset is computed by reference to the allocable ADSP amount for that asset. Except as provided in section 7701(g) (relating to fair market value in the case of nonrecourse indebtedness), the ADSP is allocated among target assets for this purpose under the principles of § 1.338(b)–2T (without taking into account § 1.338(b)–2T(c)(2)). Appropriate adjustments to reflect accurately the fair market value of assets must be made if stock of a target affiliate is purchased in the section 338(a)(1) deemed sale, a section 338 election is made for the target affiliate, and target recognizes no gain or loss on the deemed sale of the target affiliate stock under paragraph (c) of this section. See *Example 4* of paragraph (d)(8) of this section.

(3) *Deemed sale gain. Deemed sale gain* is gain (or loss) that is recognized in the section 338(a)(1) deemed sale. For purposes of subtitle A of the Internal Revenue Code, deemed sale gain is taken into account by treating the old target as if, on the acquisition date, it sold all of its assets to an unrelated person in the deemed sale. See § 1.338–2(d)(1). For example, section 267 does not apply to loss recognized on the deemed sale.

(4) *Classes of assets.* The classes of assets are defined in § 1.338(b)–2T(b).

(c) *Deemed sale of target affiliate stock*—(1) *In general.* This paragraph (c) prescribes rules relating to the treatment of gain or loss realized on the deemed sale of stock of a target affiliate where a section 338 election (but not a section 338(h)(10) election) is made for the target affiliate. For purposes of this paragraph (c), the definition of domestic corporation in § 1.338–1(c)(5) is applied without the exclusion therein for DISCs, corporations described in section 1248(e), and corporations to which an election under section 936 applies.

(2) *General rule.* Except as otherwise provided in this paragraph (c), if a section 338 election is made for target, no gain or loss is recognized by target on the deemed sale of stock of a target affiliate having the same acquisition date and for which a section 338 election is made if—

(i) Target directly owns stock in the target affiliate satisfying the requirements of section 1504(a)(2);

(ii) Target and the target affiliate are members of a consolidated group filing a final consolidated return described in § 1.338–1(e)(1); or

(iii) Target and the target affiliate file a combined return under § 1.338–1(e)(4).

(3) *Deemed sale of foreign target affiliate by a domestic target.* Gain or loss is recognized by a domestic target on the deemed sale of stock of a foreign target affiliate. For the proper treatment of such gain or loss, see, e.g., sections 1246, 1248, 1291 *et seq.*, and 338(h)(16) and § 1.338–5.

(4) *Deemed sale producing effectively connected income.* Gain or loss is recognized by a foreign target on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) *Deemed sale of insurance company target affiliate electing under section 953(d).* Gain (but not loss) is recognized by a domestic target on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized or the earnings and profits described in section 953(d)(4)(B).

(6) *Deemed sale of DISC target affiliate.* Gain (but not loss) is recognized by a foreign or domestic target on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized or the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 995(c)(2) and 996(g).

(7) *Anti-stuffing rule.* If an asset the adjusted basis of which exceeds its fair market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate's stock, the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

(8) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. (a) P makes a qualified stock purchase of T and makes a section 338 election for T. T's sole asset, all of the T1 stock, has a basis of $50 and a fair market value of $150. T's deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1's assets have a basis of $50 and a fair market value of $150.

(b) T realizes $100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.

(c) T1 recognizes gain of $100 on the deemed sale of its assets.

Example 2. The facts are the same as in *Example 1*, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 3. (a) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of T1 and T2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of T1 and T2 and a section 338 election is made for T1 and T2. T1 and T2 each own 50% of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3. T is the common parent of a consolidated group and all of the deemed sales are reported on the T group's final consolidated return. See § 1.338–1(e)(1).

(b) Because T, T1, T2 and T3 are members of a consolidated group filing a final consolidated return, no gain or loss is recognized by T, T1 or T2 on their respective deemed sales of target affiliate stock.

Example 4. (a) T's sole asset, all of the FT1 stock, has a basis of $25 and a fair market value of $150. FT1's sole asset, all of the FT2 stock, has a basis of $75 and a fair market value of $150. FT1 and FT2 each have $50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of $125 and a fair market value of $150, and their sale would not generate subpart F income under section 951. The sale of the FT2 stock or assets would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(b) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(c) T recognizes $125 of gain on the deemed sale of the FT1 stock under paragraph (c)(3) of this section. FT1's $75 of gain on the deemed sale of the FT2 stock is not recognized under paragraph (c)(2) of this section. FT2 recognizes $25 of gain on the deemed sale of its assets. The $125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization ($50 of accumulated earnings and profits in FT1, $50 of accumulated earnings and profits in FT2, and $25 of deemed sale earnings and profits in FT2). § 1.338–5(b). For purposes of sections 901 through 908, the source and foreign tax credit limitation basket of $25 of the recharacterized gain on the deemed sale of the FT1 stock is determined under section 338(h)(16).

(d) *Determination of ADSP*—(1) *General rule.* The ADSP is the sum of—

(i) The grossed-up basis of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A));

(ii) The liabilities of new target (including any tax liabilities resulting from the deemed sale); and

(iii) Other relevant items.

(2) *Grossed-up basis of the purchasing corporation's recently purchased target stock.* The grossed-up basis of the purchasing corporation's recently purchased target stock is an amount equal to the purchasing corporation's basis in recently purchased target stock, divided by the percentage of target stock (by value) attributable to that recently purchased target stock. If target has a single class of outstanding stock, the grossed-up basis of the purchasing corporation's recently purchased target stock reflects the total price the purchasing corporation would have paid for all outstanding target stock had it purchased all such stock for a price per share equal to the average price per share that it paid for the recently purchased target stock.

(3) *Liabilities.* Liabilities taken into account are the liabilities of new target described in § 1.338(b)–1(f). The amount of the liabilities of new target taken into account to calculate ADSP is determined as if old target had sold its assets to an unrelated person for consideration that included the liabilities. Thus, the ADSP takes into account both tax credit recapture liability arising by reason of the deemed sale and the tax liability on deemed sale gain. The ADSP reflects the fact that deemed sale gain (loss) both increases (decreases) the ADSP by creating (reducing) a tax liability and is computed by reference to the ADSP.

(4) *Other relevant items.* Other relevant items include reductions for acquisition costs of the purchasing corporation incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased target stock (e.g., brokerage commissions and any similar costs paid by the purchasing corporation to acquire target stock).

(5) *Calculation of deemed sale gain and loss.* Deemed sale gain on each asset is computed by reference to the ADSP. In certain cases, the determination of the tax liability resulting from the deemed sale and therefore the determination of the ADSP may require trial and error computations.

(6) *Other rules apply in determining ADSP.* The ADSP may not be applied in such a way as to contravene other applicable rules. For example, a capital loss cannot be applied to reduce ordinary income in calculating the tax liability on the deemed sale for purposes of determining the ADSP.

(7) *Cross-reference.* See § 1.338(b)–3T(h) for adjustments to ADSP because of events occurring after the acquisition date and § 1.338(h)(10)–1(f) for the determination of modified ADSP.

(8) *Examples.* (i) For purposes of the examples in this paragraph (d)(8), unless otherwise stated, T is a calendar year taxpayer that files separate returns and that has no loss, tax credit, or other carryovers to Year 1. Depreciation for Year 1 is not taken into account. T has no liabilities other than a federal income tax liability resulting from the deemed sale of assets, and T has no other relevant items. Assume that T's tax rate for any ordinary income or net capital gain resulting from

the deemed sale of assets is 34 percent and that any capital loss is offset by capital gain. On July 1 of Year 1, P purchases all of the stock of T and makes a section 338 election for T.

(ii) This paragraph (d) may be illustrated by the following examples:

Example 1. One class. (a) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of $50,400, a recomputed basis of $80,000, and a fair market value of $100,000. P purchases all of the T stock for $75,000.

(b) The ADSP may be determined as follows. (In the formula below, G is the grossed-up basis in P's recently purchased T stock, L is T's liabilities other than T's tax liabilities for deemed sale gain determined by reference to the ADSP, T_R is the applicable tax rate, and B is the adjusted basis of the asset deemed sold.)

$ADSP=G+L+T_R \times (ADSP-B)$

$ADSP=(\$75{,}000/1)+\$0+.34 \times (ADSP-\$50{,}400)$

$ADSP=\$75{,}000+.34ADSP-\$17{,}136$

$.66ADSP=\$57{,}864$

$ADSP=\$87{,}672.72$

(c) Because the ADSP for T ($87,672.72) does not exceed the fair market value of T's asset ($100,000), a Class III asset, T's entire ADSP is allocated to that asset. Thus, T has deemed sale gain of $37,272.72 (consisting of $29,600 of ordinary income and $7,672.72 of capital gain).

(d) The facts are the same as in paragraph (a) of this *Example 1*, except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for $60,000. The grossed-up basis in P's recently purchased T stock (G) is $75,000 ($60,000/.8). Consequently, the ADSP and deemed sale gain are the same as in paragraphs (b) and (c) of this *Example 1*.

(e) The facts are the same as in paragraph (a) of this *Example 1*, except that T also has goodwill (a Class V asset) with an appraised value of $10,000. The results are the same as in paragraphs (b) and (c) of this *Example 1*. Because the ADSP does not exceed the fair market value of the Class III asset, no amount is allocated to the Class V assets (assets in the nature of goodwill and going concern value).

Example 2. More than one class. (a) P purchases all of the T stock for $140,000. On July 1 of Year 1, T has liabilities (not including the tax liability for deemed sale gain of its assets) of $50,000, cash (a Class I asset) of $10,000, readily marketable securities (a Class II asset) with a basis of $4,000 and a fair market value of $10,000, goodwill (a Class V asset) with a basis of $3,000, and the following Class III assets:

Asset	Basis	FMV	Ratio
1. Land	$5,000	$35,000	.14
2. Inventory	10,000	50,000	.20
3. Equipment A (recomputed basis $80,000)	5,000	90,000	.36
4. Equipment B (recomputed basis $20,000)	10,000	75,000	.30
Totals	$30,000	$250,000	1.00

(b) The ADSP exceeds $20,000. Thus, $10,000 of the ADSP is allocated to the cash and $10,000 to the marketable securities. Except as provided in section 7701(g), the amount allocated to an asset (other than a Class V asset) cannot exceed its fair market value. See § 1.338(b)–2T(c)(1) (relating to fair market value limitation).

(c) The portion of the ADSP allocable to the Class III assets is preliminarily determined as follows. (In the formula, the amount allocated to the Class I assets is referred to as *I* and the amount allocated to the Class II assets as *II*.)

$ADSP_{III} = (G-(I+II))+L+T_R \times [(II-B_{II}) + (ADSP_{III}-B_{III})]$

$ADSP_{III} = (\$140{,}000 - (\$10{,}000+\$10{,}000)) + \$50{,}000 + .34 \times [(\$10{,}000-\$4{,}000) + (ADSP_{III} - (\$5{,}000+\$10{,}000+\$5{,}000+\$10{,}000))]$

$ADSP_{III}=\$161{,}840+.34ADSP_{III}$

$.66ADSP_{III}=\$161{,}840$

$ADSP_{III}=\$245{,}212.12$

(d) Because, under the preliminary calculations of the ADSP, the amount to be allocated to the Class I, II, III, and IV assets does not exceed their aggregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of $3,000. The portion of the ADSP allocable to the Class III assets is finally determined by taking into account this loss as follows:

$ADSP_{III} = (G - (I + II)) + L + T_R \times [(II - B_{II}) + (ADSP_{III} - B_{III}) + (ADSP_V - B_V)]$

$ADSP_{III} = (\$140{,}000 - (\$10{,}000 + \$10{,}000)) + \$50{,}000 + .34 \times [(\$10{,}000 - \$4{,}000) + (ADSP_{III} - \$30{,}000) + (\$0 - \$3{,}000)]$

$ADSP_{III} = \$160{,}820 + .34ADSP_{III}$

$.66ADSP_{III}= \$160{,}820$

$ADSP_{III} = \$243{,}666.67$

(e) The allocation of $ADSP_{III}$ among the Class III assets is in proportion to their fair market values, as follows:

Asset	ADSP	Gain
1. Land	$34,113.33	$29,113.33 (capital gain)
2. Inventory	48,733.34	38,733.34 (ordinary income)
3. Equipment A	87,720.00	82,720.00 (75,000 ordinary income 7,720 capital gain)

Asset	ADSP	Gain
4. Equipment B	73,100.00	63,100.00 (10,000 ordinary income 53,100 capital gain)
Totals	243,666.67	213,666.67

Example 3. More than one class. (a) The facts are the same as in *Example 2*, except that P purchases the T stock for $150,000, rather than $140,000.

(b) As in *Example 2*, the ADSP exceeds $20,000. Thus, $10,000 of the ADSP is allocated to the cash and $10,000 to the marketable securities.

(c) The portion of the ADSP allocable to the Class III assets as preliminarily determined under the formula set forth in paragraph (c) of *Example 2* is $260,363.64. The amount allocated to the Class III assets cannot exceed their aggregate fair market value ($250,000). Thus, preliminarily, the ADSP amount allocated to Class III assets is $250,000.

(d)(1) Based on the preliminary allocation, the ADSP is determined as follows: (In the formula, the amount allocated to the Class I assets is referred to as *I*, the amount allocated to the Class II assets as *II*, and the amount allocated to the Class III assets as *III*.)

$$ADSP = G + L + T_R \times [(II - B_{II}) + (III - B_{III}) + (ADSP - (I + II + III + B_V))]$$

$$ADSP = \$150{,}000 + \$50{,}000 + .34 \times [(\$10{,}000 - \$4{,}000) + (\$250{,}000 - \$30{,}000) + (ADSP - (\$10{,}000 + \$10{,}000 + \$250{,}000 + \$3{,}000))]$$

$$ADSP = \$200{,}000 + .34ADSP - \$15{,}980$$

$$.66ADSP = \$184{,}020$$

$$ADSP = \$278{,}818.18$$

(2) Because the ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, and IV assets, the $250,000 amount preliminarily allocated to the Class III assets is appropriate. Thus, the amount of the ADSP allocated to Class III assets equals their aggregate fair market value ($250,000), and the allocated ADSP amount for each Class III asset is its fair market value. Further, because there are no Class IV assets, the allocable ADSP amount for the Class V asset (goodwill) is $8,818.18 (the excess of the ADSP over the aggregate ADSP amounts for the Class I, II, and III assets).

Example 4. Amount allocated to T1 stock. (a) The facts are the same as in *Example 2*, except that T owns all of the T1 stock (instead of the inventory), and T1's only asset is the inventory. The T1 stock and inventory each have a fair market value of $50,000, and the inventory has a basis of $10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than a tax liability resulting from the deemed sale gain. Under paragraph (c) of this section, T recognizes no gain or loss on its deemed sale of T1 stock.

(b) The ADSP exceeds $20,000. Thus, $10,000 of the ADSP is allocated to the cash and $10,000 to the marketable securities.

(c) T1 stock is purchased in the deemed sale of T assets, T does not recognize any gain on the deemed sale of the T1 stock under paragraph (c) of this section, and a section 338 election is made for T1. Thus, under paragraph (b)(2) of this section, in determining the allocation of ADSP among T's Class III assets, including the T1 stock, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets. In preliminarily calculating $ADSP_{III}$ in this case, the T1 stock can be disregarded and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, $ADSP_{III}$ is $243,666.67. See paragraph (d) of *Example 2*.

(d) Because the portion of the preliminary ADSP allocable to Class III assets ($243,666.67) does not exceed their fair market value ($250,000), no amount is allocated to Class V assets for T. Further, this amount ($243,666.67) is allocated among T's Class III assets in proportion to their fair market values. See paragraph (e) of *Example 2.* Tentatively, $48,733.34 of this amount is allocated to the T1 stock.

(e) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to $13,169.34 (.34 × ($48,733.34 − $10,000)). Thus, the ADSP allocable to the Class III assets of T, and the allocable ADSP amount for the T1 stock, as preliminarily calculated, each must be reduced by $13,169.34. Consequently, these amounts, respectively, are $230,497.33 and $35,564.00. In determining the ADSP for T1, the grossed-up basis of T's recently purchased T1 stock is $35,564.00.

(f) The facts are the same as in paragraph (a) of this *Example 4*, except that the T1 inventory has a $12,500 basis and a $62,500 value, the T1 stock has a $62,500 value, and T owns 80% of the T1 stock. In preliminarily calculating $ADSP_{III}$, the T1 stock can be disregarded but, because T owns only 80% of the T1 stock, only 80% of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80% of these amounts, the remaining calculations and results are the same as in paragraphs (b), (c), (d), and (e) of this *Example 4*, except that the grossed-up basis in T's recently purchased T1 stock is $44,455.00 ($35,564.00/0.8).

[T.D. 8515, 59 FR 2969, Jan. 20, 1994; as amended by T.D. 8711, 62 FR 2268, Jan. 16, 1997]

§ 1.338–4 Asset and stock consistency.

(a) *Introduction*—(1) *Overview*. This section implements the consistency rules of sections 338(e) and (f). Under this section, no election under section